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# NetApp, Inc. (NTAP)

Q2 2023 Earnings Call

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good day, and welcome to the NetApp Second Quarter Fiscal Year 2023 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, this event is being recorded.

I would now like to turn the conference over to Kris Newton, Vice President of Investor Relations. Please go ahead.

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### Kris Newton

*Vice President-Investor Relations, NetApp, Inc.*

Hi, everyone, thanks for joining us. With me today are our CEO, George Kurian, and CFO, Mike Berry. This call is being webcast live and will be available for replay on our website at netapp.com.

During today's call, we will make forward-looking statements and projections with respect to our financial outlook and future prospects, such as our guidance for third quarter and fiscal year 2023; our expectations regarding future revenue, profitability, and shareholder returns; our alignment with industry megatrends and expectations regarding the future growth in number of cloud customers and their usage of cloud services; our ability to deliver innovation and focus on strategic growth opportunities while optimizing our operating costs; and our ability to drive sustained growth in both our Hybrid Cloud and Public Cloud segments in a turbulent macroeconomic environment; all of which involve risk and uncertainty.

We disclaim any obligation to update our forward-looking statements and projections. Actual results may differ materially for a variety of reasons, including macroeconomic and market conditions such as inflation, rising interest rates and foreign exchange volatility, the continuing impact and uneven recovery of the COVID-19 pandemic, including the resulting supply chain disruptions; and the IT capital spending environment, including the focus on optimization of cloud spending; as well as our ability to keep pace with the rapid industry, technological and market trends and changes in the markets in which we operate, execute our evolved cloud strategy and introduce and gain market acceptance for our products and services, and manage our gross profit margins and generate greater cash flow.

Please also refer to the documents we file from time-to-time with the SEC, and available on our website, specifically our most recent Form 10-K and Form 10-Q including in the Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors sections.

During the call all financial measures presented will be non-GAAP unless otherwise indicated. Reconciliations of GAAP to non-GAAP estimates are posted on our website.

I'll now turn the call over to George.

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### George Kurian

*Chief Executive Officer & Director, NetApp, Inc.*

Thanks, Kris and welcome everyone to our Q2 FY 2023 earnings call. Coming off a strong Q1, our team delivered a solid quarter, with all-time highs for Q2 billings, revenue, gross profit dollars, operating income and EPS. We

remain focused on disciplined operational management and the execution of our strategy, which is tightly aligned with customer priorities.

On today's call, I will walk through four topics, one, we delivered a good quarter in a dynamic environment. However, we are disappointed with the deceleration of growth in our cloud services. Our conviction in the cloud opportunity and our ability to execute against it is unwavering.

Two, we are aligned with the durable, megatrends of data-driven digital and cloud transformations. We continue to deliver innovation that furthers our already strong position. Three, we believe strongly in the opportunity ahead but have slightly tempered our revenue outlook for the remainder of the fiscal year due to near-term macro headwinds. Four, we understand the imperative to deliver shareholder value in a slowing environment and will focus on our strategic growth opportunities while continually optimizing our operating costs.

Let's start with the first point, our performance in the quarter. Q2 Public Cloud segment revenue increased 63% year over year to \$142 million and dollar-based net revenue retention rate remained healthy at 140%. However, Public Cloud ARR of \$603 million fell short of our expectations.

As our cloud partners discussed on their earnings calls, growth has slowed as customers look to optimize cloud spending. This macro-related optimization caused some slowing of growth in our cloud storage services as well. Additionally, we had a few customers with very large project-based workloads, like chip design that came to their natural conclusion, resulting in capacity reductions in those environments.

We expect these customers to kick off new projects early next calendar year. As the number of cloud customers and their usage of our cloud services grows, the impact of this type of workload will be smoothed over a much broader customer base.

In our cloud operations portfolio, Spot is benefiting from the same desire to optimize cloud spending that was a headwind to our cloud storage services. Spot's value proposition is a strong engine for new logo acquisition and Q2 saw an acceleration of new Spot customer additions from Q1. As we've discussed on past calls, we continue to refine our approach to Cloud Insights and are seeing early positive signs, with the growth of new Cloud Insights customers in Q2.

We continue to see healthy growth of new to NetApp customers and of existing NetApp enterprise customers adopting our cloud services. And those customers are growing in scale, as well. The number of customers with greater than \$1 million in ARR has more than doubled from Q1 last year.

Our Public Cloud services are highly differentiated and create customer preference for NetApp. We have a multiyear advantage over our traditional competitors in this critical market, positioning us well to deliver sustained growth.

Compared to Q2 a year ago, Hybrid Cloud revenue grew 3% and our all-flash array business increased 2% to an annualized revenue run rate of \$3.1 billion. Adjusting for the significant FX headwinds, Hybrid Cloud grew 8% and all-flash grew 7% in constant currency. All flash penetration of our installed base grew to 33% of installed systems. Our lower cost, capacity-oriented all-flash arrays and FAS hybrid flash arrays both performed well.

On to the second point, our alignment to the industry megatrends and our continued innovation. The world is moving faster than ever, raising data-driven digital and cloud transformations to business necessities. NetApp

helps meet these objectives with a modern approach to hybrid multicloud infrastructure and data management that we term the evolved cloud.

We provide customers the ability to leverage data across their entire estate with simplicity, security, and sustainability, which increases our relevance and value to our customers. We believe strongly in the sizeable, durable and growing opportunity created by these megatrends.

As many of you know, we bring significant value to customers running VMware environments on-premises. With a series of announcements made in conjunction with VMware, we are now able to bring that same value to customers in the cloud.

Our native cloud storage service integrated with VMware helps customers quickly, easily, and cost effectively migrate enterprise workloads to the cloud and accelerate modern application development using Kubernetes.

We are the only certified and supported third-party cloud storage solution for VMware Cloud, which creates significant new opportunity for us. As those VMware environments move to the cloud, we can capture the data that resides on competitors' on-premises systems.

At the start of November, we introduced BlueXP, the next big step in fulfilling our vision to give customers the simplicity, security, savings and sustainability needed for an evolved cloud. It delivers true hybrid multicloud operations by bringing storage and data services together in a single, unified control plane.

BlueXP is a highly differentiated solution that enables customers to deploy, discover, manage, and optimize not only infrastructure and data, but supporting business processes across multiple clouds and on-premises environments.

In addition to bringing forward technical capabilities, we are helping customers achieve their environmental goals by creating energy efficient products. We've added power and temperature reporting in Cloud Insights to give customers a real-time view into energy expenditure and our carbon footprint reports provide a reasonable estimate for the carbon impact of their NetApp systems.

We enhanced our storage efficiency with a 4:1 efficiency guarantee for SAN workloads to help customers minimize their storage footprint and lower energy usage. We not only help customers practice sound environmental stewardship, we practice it ourselves. I am proud to announce that EcoVadis, the leading evidence-based ESG rating agency, awarded NetApp a gold ranking, placing us within the top 7% of evaluated companies.

Now the third point, the macro environment and our business outlook. As we moved through the quarter, we saw increased budget scrutiny, requiring higher level approvals, which resulted in smaller deal sizes, longer selling cycles, and some deals moving out of the quarter.

In Q2, we felt this most acutely in the Americas hi-tech and service provider sectors. We see no change to our underlying opportunity and are confident in our position. However, current economic realities and unprecedented FX headwinds are and will continue to impact IT spending, causing us to temper our revenue expectations for the second half.

And finally, point four, driving shareholder value. In response to the slowing top line, we are being agile and taking action to lower operating expenses. Already, we have implemented a broad-based hiring freeze and are reducing

discretionary spending, as well as further optimizing our real estate footprint. We will remain disciplined as we continue to shift resources away from lower yield activities to our biggest opportunities.

In closing, we are clearly aligned with our customers' strategic priorities and remain confident in our long-term opportunity, despite the current external headwinds. By focusing on what we can control, we will aggressively seek to maximize the near-term return on our product and services portfolio while leveraging our leadership position in all-flash, cloud storage, and cloud infrastructure optimization.

I would like to thank the entire NetApp team for delivering a strong first half. In a challenging environment, we remain focused on innovation, execution, and operational discipline.

I'll now turn the call over to Mike.

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## Michael J. Berry

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

Thank you, George. Good afternoon everyone and thank you for joining us. Before we go through the financial details, I think it would be valuable to walk you through the key themes for today's discussion.

Number one, as George highlighted, we delivered a strong Q2 in a dynamic environment with all-time Q2 company highs for billings, revenue, gross profit dollars, operating income and EPS.

Number two, we have adjusted our outlook for the second half of the fiscal year due to an increasingly challenging macroeconomic environment and unprecedented FX headwinds.

Number three, as we navigate through the current macro environment, we are laser focused on driving operating margins and free cash flow generation. As George noted, we have taken actions to reduce our full year expense envelope and will remain fluid in assessing further opportunities to take costs out of the business.

Number four, as a result of these cost savings measures, the entirety of the Op margin and EPS guidance revision for the full year is being driven by the incremental 1 to 2 points from the deepening currency costs we have seen since our Q1 call.

And number five, we continue to expect to generate greater than \$1.4 billion in operating cash flow and \$1.1 billion in free cash flow for the full year. From a capital allocation perspective, we will continue to pause cloud operations acquisitions for the remainder of fiscal 2023. We now plan to return more than 100% of fiscal 2023 free cash flow to investors through dividends and incremental share repurchases.

Now to the details. As a reminder, I'll be referring to non-GAAP numbers unless otherwise noted. Q2 billings were \$1.6 billion, up 3% year-over-year. Revenue came in at \$1.66 billion, up 6% year-over-year. Adjusting for the 540 basis point headwind from FX, billings and revenue would have been up 9% and 12% year-over-year respectively. Even with the challenging Q2, our cloud portfolio continues to positively impact the overall growth profile of NetApp delivering 3.5 of the 6 points in revenue growth.

Hybrid Cloud segment revenue of \$1.52 billion was up 3% year-over-year. Product revenue of \$837 million increased 3% year-over-year. Total Q2 recurring support revenue of \$607 million increased 3% year-over-year, highlighting the health of our installed base.

Public Cloud ARR exited Q2 at \$603 million, up 55% year-over-year. Public Cloud revenue recognized in the quarter was \$142 million, up 63% year-over-year and 8% sequentially. Recurring support and Public Cloud revenue of \$749 million was up 11% year-over-year or 16% in constant currency, constituting 45% of total revenue.

We ended Q2 with \$4.1 billion in deferred revenue, an increase of 5% year-over-year or 10% in constant currency. Q2 marks the 19th consecutive quarter of year-over-year deferred revenue growth, which is the best leading indicator for recurring revenue growth.

Total gross margin was 66.3% in line with our guidance. Total Hybrid Cloud gross margin was 66% in Q2, including a 2 point year-over-year headwind from FX. Within our Hybrid Cloud segment, product gross margin was 50%, including a 3 point year-over-year headwind from FX.

Our growing recurring support business continues to be very profitable with gross margin of 93%. Public Cloud gross margin of 68% was accretive to the corporate average for the eighth consecutive quarter. We remain confident in our long-term Public Cloud gross margin goal of 75% to 80%, as the business scales and an increasing percentage of our Public Cloud revenue is driven by cloud and software solutions.

Q2 highlighted the strong leverage in our business model with operating margin of 24%, including 2 points of FX headwinds. EPS of \$1.48 came in nicely ahead of guidance and included a \$0.21 year-over-year FX headwind.

Cash flow from operations was \$214 million and free cash flow was \$137 million. Q2 included our annual repatriation tax payment and continued cash outflows for certain inventory and premiums for constrained trailing-edge analog parts.

Additionally, collections were lower than expected due to a back-end loaded quarter for invoicing linearity that you see in the higher accounts receivable balance. Our component purchasing strategy allows us to meet as much customer demand as possible but remains a clear headwind to cash flow and gross margins.

We are seeing signs of relief in supply availability. The timing of a full supply recovery remains uncertain, however, as our inventory levels start to normalize, it will be a tailwind to free cash flow as we go through the second half of fiscal 2023.

During Q2 we repurchased \$150 million in stock and paid out \$108 million in cash dividends. In total we returned \$258 million to shareholders, representing 188% of free cash flow. Share count of 220 million was down 4% year-over-year. We closed Q2 with \$3 billion in cash and short-term investments.

Now to guidance. As George discussed, we have seen softening in the macro backdrop, with customers taking a decidedly cautious approach to spending. Additionally, currency headwinds have only continued to increase. We now expect fiscal 2023 revenue to grow 2% to 4% year-over-year, which includes 5 points of FX headwind versus the 4 point headwind assumed in our prior guidance.

We now expect to exit fiscal 2023 with Public Cloud ARR of approximately \$700 million, which equates to our Public Cloud segment driving 3 points of total company revenue growth for the full year.

Three drivers are impacting the near-term growth rate of cloud ARR. Number one, in this macro environment, we project continued optimization of storage services as we help our customers manage their spending, which benefits Spot, but will offset some incremental near-term storage services ARR.

Number two, we expect that project-based workloads will grow in both number and scale, but as they ramp it will take some time to materialize into sizable ARR. And number three, we continue to tighten up the Cloud Insights sales motion, but we don't expect this meaningful cross-sell opportunity to materialize until we head into fiscal 2024.

In fiscal 2023, we continue to expect gross margin to range between 66% and 67%, as elevated component costs and FX headwinds weigh on product margins. As you know, the vast majority of our bill of materials is procured in US dollars.

We are optimistic that supply constraints will ease further in the second half of our fiscal year, reducing our dependence on procuring parts at significant premiums. We should also see a benefit from declining NAND prices in Q4. While the timing is uncertain, we remain confident that our structural product margins will normalize back to the mid-50s in the fullness of time.

For the full year, we expect operating margin of approximately 23%, which now includes approximately 2 points of FX headwind and EPS of \$5.30 to \$5.50, which now includes more than \$0.70 of currency impacts. It's important to reiterate that we are offsetting the full year revenue adjustment with an extremely disciplined approach to our spending envelope. As a result, the entirety of the Op margin and EPS guidance revision for the full year is being driven by the incremental 1 to 2 points from the deepening currency costs we have seen since our Q1 call.

We continue to expect to generate greater than \$1.4 billion in operating cash flow and \$1.1 billion in free cash flow for the full year. From a capital allocation perspective, we will continue to pause cloud operations acquisitions for the remainder of fiscal 2023, as we sharpen our portfolio focus by refining the Cloud Insight value proposition and sales motion, accelerating the integration of Spot and CloudCheckr into a single finops suite and driving the successful integration of InstaClustr. As I have said earlier, we now plan to return more than 100% of fiscal 2023 free cash flow to investors through dividends and incremental share repurchases.

Now on to Q3 guidance. We expect Q3 net revenues to range between \$1.525 billion and \$1.675 billion which, at the midpoint implies a 1% decrease year-over-year or 4% growth in constant currency. We expect consolidated gross margin to be approximately 67% and operating margin to range between 22% and 23%. We anticipate our tax rate to be between 21% and 22%. And we expect earnings per share for Q3 to range between \$1.25 and \$1.35 per share. Assumed in our Q3 guidance is net interest income of \$5 million and a share count of approximately 220 million.

In closing, I want to thank the entire NetApp team for their continued commitment in such a dynamic environment.

I'll now hand the call back to Kris to open the call for Q&A. Kris?

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**Kris Newton**

*Vice President-Investor Relations, NetApp, Inc.*

Thanks, Mike. Operator, let's begin the Q&A.



## QUESTION AND ANSWER SECTION

**Operator:** Thank you. We will now begin the question-and-answer session. [Operator Instructions] And our first question will come from Amit Daryani with Evercore. Please go ahead. Pardon, Amit, your line might be muted.

**Abdullah Khan**

*Analyst, Evercore Group LLC*

Q

Can you hear me?

**Kris Newton**

*Vice President-Investor Relations, NetApp, Inc.*

A

Yeah, we can hear you now.

**Abdullah Khan**

*Analyst, Evercore Group LLC*

Q

Okay. So this is Abdullah speaking in for Amit. So I think your guys cloud ARR expectation is coming down by \$100 million versus prior expectations. And I just wanted to ask whether you guys could perhaps touch on the softness there? Is this more on compute storage or analytics? And maybe if there's one cloud provider where the ramps are more challenged versus not? I would appreciate any details here. Thank you.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

I think we expect to see the continuation of some of the trends that we saw in Q2, which is the consumption-oriented cloud offerings in our portfolio, which are cloud storage services were most impacted by customers wanting to reduce their spending. It could involve either them reducing the amount of capacity they use on our offerings or us proactively helping them migrate some of their workloads from a high performance tier to a more cost effective tier, so that they will continue to see value and benefit with us. That's one.

Second, we saw in Q2 some project-based workloads, for example, large-scale semiconductor design that came to its natural conclusion. We anticipate some of those workloads coming back in the early part of next calendar year, but we are being cautious about that. And then finally, with our Cloud Insights product, we have continued to work to sharpen the focus on the use case of the products. We saw some early success in terms of new customer wins – new to Cloud Insights customer wins. But we're being cautious about the future growth rate of that product until we see further evidence of success.

So I think those were the three. I did not see anything materially different between the different cloud providers. Clearly, our relationship with Microsoft is the largest of the three, given that we've worked with them for the longest and so they saw the biggest impact this quarter.

**Kris Newton**

*Vice President-Investor Relations, NetApp, Inc.*

A

All right. Thank you. Next question please.

**Operator:** Our next question will come from Mehdi Hosseini with SIG. Please go ahead.

**Mehdi Hosseini**

*Analyst, Susquehanna International Group*

Q

Yes. Thanks for taking my question. Two follow-ups. George, if I just take your guidance commentary, you suggest that all-flash array revenues should show a Q-o-Q and year-over-year decline in January quarter?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

We didn't guide anything specific in terms of all-flash array revenue. We have guided at the total company level. We're being cautious about our outlook given what we saw in the quarter and the continued macroeconomic environment. We are not guiding any specific product category maybe.

**Mehdi Hosseini**

*Analyst, Susquehanna International Group*

Q

No, just that's what I walked away with. Is that a realistic assumption for all-flash array revenues were to decline?

**Kris Newton**

*Vice President-Investor Relations, NetApp, Inc.*

A

We're not guiding down to the product line, Mehdi. Sorry, that we can't help you with that.

**Mehdi Hosseini**

*Analyst, Susquehanna International Group*

Q

Yeah. That's fine. At least I try. Just – and then a follow-up to your comment about the chip design. There's obviously a product migration. They are expected to introduce new products for AI application. You also suggested that, that should help you with a rebound in the cloud data services. And I want to better understand whether your underlying assumption, do you think that product transition is going to ramp in early calendar year. Is it – is your guide on cloud data services completely derisked given this transition. Sometimes these transitions take longer. And I'm just wondering what are the key assumptions there?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

I think with our cloud outlook, we've been cautious to address three topics, right? One is consumption services on the cloud are being impacted by customers reducing spend either by optimizing the performance level that they use or the total capacity they use in our cloud storage services. That will happen for a period of time and then we will see build back. We don't see that yet in the outlook.

I think with regard to project-based workloads, listen, there are lots of different customers with different projects. I think in this case, we saw a few large projects come off our environment. And we've been cautious about how many of those come back in terms of our outlook. It will take time for them to come back as new projects, the new chip designs. We are the only option in the Public Cloud for semiconductor chip design technologies to be verified as a cloud service.

So we expect, over time, more and more customers will use our cloud services, but that will take time. And then I think in our CloudOps portfolio, as I said, we are pleased with the work that we've done so far. There's still more work to be done. And so we're being appropriately cautious about how fast that product portfolio, especially Cloud Insights grows in the second half of this year.

**Mehdi Hosseini**

*Analyst, Susquehanna International Group*



Thank you.

**Operator:** Our next question will come from David Vogt with UBS. Please go ahead.

**David Vogt**

*Analyst, UBS Securities LLC*



Great. Thanks guys for taking my question. Hi George, hi Mike. Maybe just a big picture question on macro and linearity and how you thought about the quarter as it progressed, because obviously you did a good job of cutting costs, managing the business to the economic backdrop. But all-flash arrays were relatively weaker in the quarter, suggesting that obviously, you probably knew early in the quarter that customers were looking for more maybe cost conscious or cost effective solutions.

And you mentioned a lot of decisions were picked up to the CTO level or the CFO level. So, can you kind of discuss what you saw as the quarter progressed from a demand perspective? Was there a pivot point or was it just sort of a gradual bleed as we walk through each of the months? And how did it relate to, let's say, 90 days ago when we had this conversation? Thanks.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*



I think it got progressively worse through the quarter. I think you see us being appropriately cautious in our guide as a result as well. I think that the rate increases getting compounded at a very fast clip certainly impacted customers' business confidence, and that gotten the range of customers that were affected with their business confidence grew through the quarter and the depth of the impact on spending grew.

I don't think we saw any particularly meaningful shifts between product mix in the quarter. Hybrid flash has performed well for a few quarters now and all-flash has been – as a percentage of our total mix has been more steady than as a growing percentage of our mix. So I think – I don't think that our view of the product portfolio affected as much as the view of the total business opportunity available in customers. I'll let Mike add any color.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*



Yeah. Thanks, George. So David. Per George's comments, when we saw linearity in the quarter, month one was relatively consistent with what we've seen in, I'll call it, non-Q4 quarters. What we really saw was month two push into month three and typically, we will see, call it, mid 40% of transactions and invoices in month three. That pushed to almost 60% this quarter. So what you saw was in the second month of the quarter really started to push into the third month. And that's what we saw that really back-end linearity that I spoke about in my prepared remarks.

**David Vogt**

*Analyst, UBS Securities LLC*



Got it. And maybe just a quick follow-up for you, Mike. Just maybe on the currency headwinds, that incremental point or two. I know your business is primarily denominated in dollars. But can you kind of help us understand that transition from [ph] negative 3 to negative 4 to negative 5 (00:38:00), the US dollar has weakened a bit as of late.

Just kind of want to get a better understanding kind of what's under the surface there and what's kind of driving that incremental headwind from an FX perspective? Thanks.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Yeah. Sure, David, happy to. So the significant foreign currencies we have like most international companies, it's euro, GBP, yen and Aussie dollar. And what we saw, again, across most of those is August and September was – when the dollar was the strongest. So that's when the most significant impact hit. That stayed largely through October. Now, what we saw after our quarter ended, is, hey, it got a little bit better in November, the dollar weakened a little bit. Yeah, we'll see if that holds. Everything we've put in front of you, we have used FX rates as of the end of October.

**David Vogt**

*Analyst, UBS Securities LLC*

Q

Got it, okay.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

So – yeah, if it stays a little bit better, that will be good. But making our living betting on FX rates, we're not going to try that. So we use October rates for the rest of the year.

**David Vogt**

*Analyst, UBS Securities LLC*

Q

Yes, that's helpful. End of the mouth is great. Perfect. Thanks, Mike. Thanks, George.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Thank you, David.

**Operator:** Our next question will come from Samik Chatterjee with JPMorgan. Please go ahead.

**Angela Jin**

*Analyst, JPMorgan Securities LLC*

Q

Hi. This is Angela Jin on for Samik Chatterjee. And my first question. So, I think in your prepared remarks, you mentioned that, customer weakness was concentrated in Americas hi-tech and service provider sectors. Could we just dive more into the dynamics of each of your customer verticals and segments. Were there certain ones that held up better, enterprise versus SMB, for example? And what types of specific behaviors or patterns that you see in each vertical?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

We don't have any specific vertical that is a material contribution to our revenue. Let me start there. I think the – what we saw through the quarter was, public sector did well, both in the Americas and internationally. I thought that our European team performed exceptionally well to deliver a strong result in the face of increasing headwinds. And in our outlook for the international markets, we are appropriately cautious about Germany, where our team did phenomenally well in Q2, but there's just growing pressure economically.

I think with regard to the North American market, the midsized enterprise segment team did a good job. We saw good results there. We're cautious about the potential in that segment, given their historic vulnerability to recession and macro exposure, but our team did well in Q2. I think the larger enterprise in those specific verticals were the ones where we saw the most [audio gap] (00:39:25) substantive change in spending, and we expect them to be cautious go forward.

**Angela Jin**

*Analyst, JPMorgan Securities LLC*

Thanks.

Q

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

Last year, from a year-on-year compare, last year public – the hi-tech and service provider and the large enterprise segment did well for us. So this is a year-on-year compare, as well that we are working through.

A

**Angela Jin**

*Analyst, JPMorgan Securities LLC*

Got it. And then for my follow-up, with the cloud ARR target lowered to \$700 million, looking ahead to the out year, I'm not asking for you to predict how deep or long a potential downturn could be. But how are you thinking about [ph] just (00:40:10) to that \$2 billion cloud ARR target by fiscal year end 2026. And what gives you confidence that you can accelerate ARR in those out years?

Q

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

Hey, Angela, it's Mike. So, as we both talked about, look, we still feel really good about the cloud business, both cloud storage and CloudOps. We have some things to work through this year. So even though Q2 was not where we would like, we still feel really good about the future. We will update our views of fiscal 2024 and the \$2 billion when we give you guidance for next year. So we'll ask you to wait until we update our fiscal 2024 numbers in a couple of quarters.

A

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

I think where we are focused on at the moment with our cloud business is to make sure that we are a good partner to our customers so that we can optimize their spend where they need help doing that. We are going to be continuing to accelerate our focus on selling more of our cloud products to our installed base where today it's about 15% of our Hybrid Cloud customers have our cloud products. And we have grown the number of cloud customers and the number of them that are buying more than one cloud service. So there's lots of opportunity ahead. We're focused on blocking and tackling and executing on the opportunities in front of us.

A

**Angela Jin**

*Analyst, JPMorgan Securities LLC*

Thank you.

Q

**Operator:** Our next question will come from Krish Sankar with Cowen and Company. Please go ahead.

**Krish Sankar**

*Analyst, Cowen and Company, LLC*

Q

Yeah, hi. Thanks for taking my question. I have two of them. I'll ask both of them upfront either George or Mike. Thanks for the color on the cloud customer scenario. I'm kind of curious like one of your competitors two weeks ago mentioned the storage demand was still pretty strong from cloud customers. I'm kind of curious, is the weakness you're seeing NetApp customer specific? Or is there any kind of share loss due to competitive threats? That's the first question.

And then the follow-up is on the cloud ARR from \$800 million to \$700 million, yet we spoke about a high retention rate. So is the challenge now signing new customers with ANF, which is the ramp of AWS FSx? Any color there would be helpful on the ARR cut? Thank you.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

I think with regard to what we saw in the quarter was really we have unique cloud services, which are native, first party cloud services. Those are consumption offerings that we give customers. They were the ones most impacted. None of our competitors have native first party consumption cloud services. They offer it through the marketplace. The marketplace business for us stayed relatively consistent. And so that is what you would expect.

The subscription business is less susceptible to near-term changes in usage than the consumption business. And so the benefits of consumption being you can turn it on and off also shows up when customers want to optimize spend. We want to be a good partner to the customers that want to do that. And so we are working with our hyperscaler partners to give them access to more options to be more cost effective with their spend.

Spot, which is the compute optimization platform actually did well in the quarter. So while the storage consumption was impacted by spend, as I noted in my remarks, Spot which was a – which is a vehicle to optimize computing spend did very well in the quarter. And so we continue to help our customers through that journey. With regard to growth opportunities, listen, as I said, we felt very good about the number of customer adds. We felt very good about the amount of cross-selling we are starting to see dollar-based net retention rate has been strong, and so several good things in our cloud business.

**Krish Sankar**

*Analyst, Cowen and Company, LLC*

Q

And on the ARR side?

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

So on the ARR point, so there's been a couple of questions about the \$800 million down to the \$700 million. So when we looked at that, originally, when we had given the \$800 million, we expect it to be, call it, somewhere around \$650 million as of the end of Q2. Taking a look at the second half now, we expect to grow about \$100 million. That's all organic because we don't have any acquisitions baked in. And we expect that to continue to grow across cloud storage, specifically ANF, FSx and GCP, we all expect to see some good growth.

We have tried to be conservative or cautious, I will say, around the consumption business because we do expect that to come back in the second half. We're just not really sure if it's going to be Q3 or Q4. So we feel really good about the \$700 million, still a significant growth in that business. But stepping it down a little bit based on the Q2

results and also take a step back a little bit on Cloud Insights. So that's the – I'll call it, Krish, the product view of the rest of the year.

**Krish Sankar**

*Analyst, Cowen and Company, LLC*

Q

Got it. Thanks a lot, George. Thanks a lot, Mike.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Thank you.

**Operator:** Our next question will come from Sidney Ho with Deutsche Bank. Please go ahead.

**Sidney Ho**

*Analyst, Deutsche Bank Securities, Inc.*

Q

Thanks for taking my question. Maybe a couple more on the Public Cloud side. So on the reported quarter, your Public Cloud revenue on an annualized basis was lower than your ARR exiting last quarter. Is it fair to say that there were some cancellations and maybe some restructuring of some of the deals based on the three dynamics that you guys talked about earlier. And if so, how do you feel comfortable about the future ARR would not be reduced from the churn level?

And maybe I'll just throw in the next question here. If you look at your revised ARR with the \$700 million, if I exclude the inorganic growth and then make some certain assumptions about dollar-based net retention, you still need quite a bit of ARR coming from new customers. So in terms of new customers, which offerings are you seeing the most traction at this point? Thank you.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Hey, Sidney, it's Mike. So let me do the first one. So great question. So we finished Q1 at \$584 million in ARR. If you simply take – divide that by 4, you get about \$146 million that you'd expect to recognize in revenue. The revenue recognized in the quarter was \$142 million. And the nuance here is that typically you can make – you can do that calculation, it's going to flow very nicely because of the things that we talked about in terms of some of the consumption being reduced during the quarter, some of the project-based initiatives, especially the larger chip design wins.

Those happened during the quarter thus, we did lose some revenue that was in the ARR as of the beginning of the quarter. So that's the nuance. We don't expect to see that happen in the future. It's a great question, but it was largely due to that. The third part is the back-ended linearity on some of the subscription business that follows the NetApp, I'll call it, core business as well. So it's really those three things attributed to that revenue coming in lower than simply taking the ARR divided by 4.

**Sidney Ho**

*Analyst, Deutsche Bank Securities, Inc.*

Q

Great. And in terms of the new customers – ARR from new customers?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Listen, we had a good quarter in terms of new customer additions. We have two major vehicles for new customer additions. The first being the native cloud services that we help our cloud provider partners, Amazon, Microsoft and Google sell for us. Those continue to be good vehicles for new customer additions. And then Spot has continued to be a strong vehicle for new customer additions. So I feel good about the pace of net new customers.

**Sidney Ho**

*Analyst, Deutsche Bank Securities, Inc.*

A

Great. Thank you very much.

**Operator:** Our next question will come from Simon Leopold with Raymond James. Please go ahead.

**Victor Chiu**

*Analyst, Raymond James & Associates, Inc.*

Q

Hi, guys. This is Victor Chiu in for Simon Leopold. You noted several customers that concluded several large projects and then drove capacity reductions. Can you help clarify what changed versus your expectations exactly because [indiscernible] (00:48:33) – the way that you kind of described at the conclusions were kind of natural and then so we assumed it would have been somewhat expected. So either did they conclude earlier? I think you mentioned there were some chip design kind of timing-related issues. Can you just help us clarify why this dynamic was not expected?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Listen, I think we have seen in the past projects get concluded in a quarter and other projects get started up within the same quarter or by other customers within the quarter. This time, we saw some particularly large projects that concluded in the quarter where the start of the next project is beyond the finish of the quarter and further out than we would like. So I think that was the nature of what happened in the quarter. I think we would honestly want to get better visibility. We are working on that.

I think this is – when we have another partner selling the service to the end customer, our sales teams are working to get better visibility into the end customers, kind of priorities and spending time lines. So that's on us. We can do better on that and I [ph] acknowledge (00:49:50) that.

**Victor Chiu**

*Analyst, Raymond James & Associates, Inc.*

Q

Okay. And then just quickly, regarding your commentary on macro headwinds, are you observing explicit behavioral trends or having explicit discussions with customers that makes you confident that the slowing is specific to the macro environment versus a more secular shift like accelerating workload migrations to the Public Cloud?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

I think we are closely engaged with a large number of the enterprise customers through our direct sales force in the midsized enterprise market, as you know, we go to market with the channel providers. In terms of the customer behavior we saw in the quarter, it is very reflective of a typical macro cycle, more approvals for deals,



smaller deal sizes, projects being broken up into phases rather than one large purchase and some deals moving out of the quarter.

That did not mean that other customers did not start projects with us and move them forward. We know that those projects are – that we did not lose share to somebody else because we are in ongoing dialogue around the other phases of the projects that are yet to come online.

**Victor Chiu**

*Analyst, Raymond James & Associates, Inc.*

Q

Got it. That's helpful. Thank you.

**Operator:** Our next question will come from Meta Marshall with Morgan Stanley. Please go ahead.

**Meta A. Marshall**

*Analyst, Morgan Stanley & Co. LLC*

Q

Great, thanks. Just wanted to get a sense of whether we could get just what the size of hi-tech and service provider is as a percentage of the cloud revenue or just kind of any vertical concentration that we should be mindful of? And then maybe last quarter, you have had given kind of the storage services as a percentage of cloud ARR. If we could just have an update there, that would be helpful as well. Thanks.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Yeah. Listen, Meta, we're not going to break out specific verticals. I would just say that we saw a broad-based – hi-tech is quite a broad segment, and we saw a fairly conservative posture across that segment. Service provider could – is also broadly defined. It could be telco. It could be hosting provider. It could be some form of cloud providers. So these are broader categories than a very specific definition. And we saw a fairly conservative postures across most of those customers.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Hey, Meta, it's Mike. On your second question, so two data points for you. Cloud storage continues to be almost exactly 60% of the total and that includes, as of the end of Q2, Instacluster and CloudCheckr which are in CloudOps. So there you see the great growth we've seen in cloud storage because overall, as a total number has stayed right around 60%.

The other important number is we've talked about consumption versus subscription. As of the end of Q2, it's pretty close to 50/50, a little bit – a 2 percentage points higher for consumption. We do expect by the end of the year with that \$700 million for that to get much closer to 60%, because that's where we expect the growth across ANF, GCP and FSx, those products as well. So those are the two data points we gave you that break down that cloud ARR number.

**Meta A. Marshall**

*Analyst, Morgan Stanley & Co. LLC*

Q

Great. Thanks, so much.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Thank you.

**Operator:** Our next question will come from Ananda Baruah with Loop Capital. Please go ahead.

**Ananda Baruah**

*Analyst, Loop Capital Markets LLC*

Q

Hi, thanks guys for taking the questions. Actually two clarifications, if I could. Mike, just the remarks you made a couple of times in the prepared comments about – and this is really the clarification. FX driving sort of some portion of the guide down or whatever that context was. Could you clarify that? And then I have a quick follow-up clarification as well.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Sure, Ananda. Happy to. So that was in reference to on the Q1 call, we had given – this is directly related to EPS. We've given \$5.50 as the midpoint. Since that time, because of the continued strengthening of the dollar and the weakening of the FX situation, the \$5.40 is actually above what that number would have been on an FX adjusted basis, that's about \$5.37. The point there being, hey, we're seeing even in the second half with the lower outlook around revenue, we're doing all we can around costs and other efficiencies to ensure that we continue to still drive that EPS number consistent with the number we gave you last time on the call.

**Ananda Baruah**

*Analyst, Loop Capital Markets LLC*

Q

I got it. That's super helpful. And then, the second clarification is, to one of the questions, you mentioned, you gave some context around timing of pickup and something along – well, it was sort of – that was sort of the gist of it. But I think, Mike, the comments you made, where you expect demand to come back in the second half, though you weren't sure it was Q3 or Q4. Could you clarify that? And is it fiscal Q3, Q4? Or is it calendar 2023 Q3, Q4 in addition to the clarification. Thanks.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Sure. So I've been trained and I only talk about fiscal years, not calendar years. So this was second half fiscal, and that was directly related to the cloud ARR growth. So we finished at \$603 million. We've guided end of year to \$700 million. We are not going to guide Q3. We feel good about the second half because again, these are some of those – these large project-based as well as consumption. When does that flow in? Is it in our fiscal Q3 or Q4? We feel confident about the second half. There's a little bit of nuance around whether it's three or four, hence, we're only doing the end of the year.

**Ananda Baruah**

*Analyst, Loop Capital Markets LLC*

Q

That's super helpful. And so, was that the same, like, that anecdotally, you guys are experiencing and George, feel free to jump in on this too, anecdotally, you guys are – you're experiencing a little bit of a sideways here, call it, a pause. You anticipate that it's going to last, I guess, like [ph] to a max (00:56:18) – it's period of max six months, eight months, let's say starts slowing mid-quarter, could last an additional six months But you do expect

sort of it then pickup in some context after that. Anecdotally, is that sort of the gist of what you guys are communicating?

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Well, keep in mind, Ananda, all this is related to the cloud ARR.

**Ananda Baruah**

*Analyst, Loop Capital Markets LLC*

Q

Understood.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

This is not [indiscernible] (00:56:46) the Hybrid Cloud business. And this is more of just us talking about when we expect it to come back in the second half. And again, because of the large project base, that's really the nuance on this more than anything versus us calling, hey, we expect to see things pick up after April.

**Ananda Baruah**

*Analyst, Loop Capital Markets LLC*

Q

Got it, got it, got it. Okay, cool. Thanks guys. Appreciate it.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Thank you.

**Operator:** Our next question will come from Jim Suva with Citigroup. Please go ahead.

**Jim Suva**

*Analyst, Citigroup Global Markets, Inc.*

Q

Thank you. Good afternoon. George, on your outlook and Mike, on your outlook, you mentioned about slowing economic comments, which is understood. Any thoughts around inventory digestion, is there a sense that there's inventory digestion out there. And if so, how long or any double ordering? Or is it just purely kind of economic pausing and elongation of cycles?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

We did not see any order cancellations or any of those things. As we have mentioned repeatedly, we have good line of sight into our customer's spending priorities and behaviors and are directly engaged with the largest of them. I think as we saw in this quarter, and we continue to be cautious about looking at the second half of the year. These are clearly related to IT budget revisions, right, where they are reducing deal sizes or scrutinizing projects and things, we'll defer a portion of that project to a subsequent quarter or a subsequent part of the calendar year. So we have good visibility into the activities in our customers, and we did not see cancellations of orders because of prior orders or double ordering.

**Jim Suva**

*Analyst, Citigroup Global Markets, Inc.*

Q

Great. Thanks. But on the inventory digestion, any thoughts of – were there any inventory that's still being digested that may allow corporate or servicing providers to prolong these revisions? Or is any concern about inventory out there?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Typically, during macro situations like these, we have seen customers sweat their assets, right. And so what we mean by that is they will drive a system to a higher level of utilization and so that they can defer either capacity augmentation or system upgrades for a period of time. Now that's not forever, right? Storage is consumed because data keeps growing. And so there's always that trade-off. We certainly see some of that behavior going on. Jim, I think certainly in our service provider segment, we see that. And in some of the hi-tech verticals, we saw that as well.

**Jim Suva**

*Analyst, Citigroup Global Markets, Inc.*

Q

Great. Thank you so much for the details and clarifications.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Yes. Thank you.

**Operator:** Our next question will come from Tim Long with Barclays. Please go ahead.

**George Wang**

*Analyst, Barclays Investment Bank*

Q

Hey, guys. It's actually George Wang on for Tim Long. Yeah, I have two questions. Firstly, George, maybe you can elaborate on the current state of the deal integration in terms of Spot, Instacluster. And any thought process behind the [ph] pausing (01:00:09) deal until FY 2024?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Listen, we have a good portfolio of technologies already. And what we are really focused on is sharpening the use cases that are best suited to the current macro environment and making those use cases easy for the customers to adopt, expand and renew, right? And that operational focus is our highest priority. There are some – there's work to be done to integrate the CloudCheckr capabilities into the Spot suite so that it becomes one broader offering rather than two parallel offerings. We have made good progress along the way, but there's more work to be done.

In Instacluster, there are two unique value adds that we bring. One is the integration of our cloud storage services and Spot services into Instacluster. And the second is the fact that it is a truly open-source data services platform. We have the first of those two being worked. And so we feel like there's a lot of value we already have in our portfolio. There's work to be completed, and we want to keep our teams focused on that work on the technology side.

On the go-to-market side, we also have more broad enablement and training for our sales teams to be able to position Spot and InstaClustr and CloudCheckr into the account. So we feel good about the work we're doing. We got to finish it before we look at other things.

**George Wang**

*Analyst, Barclays Investment Bank*

Q

Okay, cool. Yeah, a quick follow-up is on the cost cuts. Maybe you can elaborate on the kind of disaggregate just components for the cost cuts, whether that's sales and marketing, the SG&A or kind of more – some of the R&D? Any color would be appreciated.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Hey, George, it's Mike. And just I want to make sure your question was the – what are we looking at for cost reductions in the second half? Was that the question?

**George Wang**

*Analyst, Barclays Investment Bank*

Q

Yeah.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Yeah. Perfect. Thank you. So hey, there's several that I think you're going to see flow through the P&L. I'm going to start all the way at the top, which is we do expect to finally see some relief from our significant expenditures related to premiums. The supply chain is getting a little bit better. It gets better every day. So that's going to help the second half. In addition, NAND pricing will help us as well. Now we do have a little bit of inventory to work through. And you'll see that still in Q3, but we expect by Q4, you'll see that as well.

On the OpEx side, look we're – George talked about and we've already done a head count freeze. We're taking a look at all discretionary spending, including travel, programs, outside services, just like everybody else who has embraced the hybrid work environment. We'll take a hard look at our facilities costs as well.

So we've already started down the path on several of those as I talked about, hey, we'll continue to look at those as we go into the second half. So there's numerous areas for us to focus on. In addition, keep in mind, too, that in OpEx, there's a good bit of a – that cost structure related to incentive comp and commissions. And certainly, those will come down in the second half as well.

**George Wang**

*Analyst, Barclays Investment Bank*

Q

Okay, great. Thank you.

**Operator:** Our next question will come from Nehal Chokshi with Northland Capital Markets. Please go ahead.

**Nehal Chokshi**

*Analyst, Northland Securities, Inc.*

Q

Yeah, thanks. So the total revenue guidance is lowered by 400 basis points that characterizes 100 basis points due to incremental FX, another 100 basis points due to lower PCS and ARR target. And then the remaining 200

basis points either due to weaker billings results on a constant currency basis during the quarter? Or is it a weaker billings result that has started to transpire during the third quarter, again on a constant currency basis?

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

So for the second half, Nehal that is mostly related to product revenue, which would be largely booked and recognized in the quarter. So it's – there's – backlog is largely at the normal rates, the seasonal normal rates that we would expect. So that is going to be systems in the second half, I think is the third part of your question.

**Nehal Chokshi**

*Analyst, Northland Securities, Inc.*

Q

Excellent. Okay. And then dollar-based net revenue retention rate declined quite significantly, 192% to 140%. Is this largely because of the project-related stuff?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Dollar-based net revenue retention was 150% last quarter, and it's now 140%. So step down as the base of customers expand, and we did see some churn in our consumption business, as we noted on our call, so we don't see that as materially different than what we would expect.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

And to George's point, Nehal, we've been calling that for several quarters, which is add that ARR number gets bigger, that dollar-based net retention percentage will come down. We like to call it the 120%, 130%, where we think it will land, but we have been calling that percentage to continue to decline as that number increases.

**Nehal Chokshi**

*Analyst, Northland Securities, Inc.*

Q

That you have. Okay. And then just finally, Mike, the [ph] PCS GM (01:05:31) did come down both Q-o-Q and year-over-year. Why is that?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

The PCS gross margin came down because of the revenue scale relative to the infrastructure that we have deployed. Note that the consumption business, some elements of those are based on our deployed systems, right, in the cloud provider environments. And when they have less scale, you see less utilization, you see less gross margin.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

Yeah. It came down from 69.7% to 68.3%, so down slightly. And to George's point, that's largely due to scale. We continue to feel good, as I mentioned in my notes about the 75% to 80% as we drive that scale.

**Nehal Chokshi**

*Analyst, Northland Securities, Inc.*

Q

Thank you.

**Operator:** Our next question will come from Wamsi Mohan with Bank of America. Please go ahead.

**Wamsi Mohan**

*Analyst, BofA Securities, Inc.*

Q

Yes. Thank you. I appreciate the fiscal year guide. But George, you were talking earlier about IT budgets and some caution around that. I was wondering if you could share some color on what you're hearing from customers more around calendar 2023 IT budgets? And what's your view on how you expect the storage market to grow in 2023 and your growth relative to that? And I have a follow-up.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

I think with regard to 2023, we're being cautious we aren't guiding next fiscal year, but we are being cautious about the start to calendar year 2023. We have seen typically in these macro situations that new budget outlays to start a calendar year probably take longer than typical. So we've been cautious about the start of the new calendar year.

With regard to the storage market overall, I think it's going to be paced by new workload deployments. I think there will be customers that will be forced to upgrade systems because their existing systems are coming to either end of useful life or end of they're just out of capacity or performance. But I think the majority will prioritize new workload deployments and/or system consolidation for cost and energy benefit use cases.

We continue to see – while the cloud migrations are slowing down a bit, we continue to see that as a long-term trend that customers are going to take on for a whole bunch of reasons. And so I think cloud will outpace on-prem in the broader market. And in the on-prem world, we see NAND helping flash be a bigger part of the mix going forward. Our capacity flash products had a good quarter, our hybrid flash products had a good quarter. They are typical about where customers are cost conscious.

**Wamsi Mohan**

*Analyst, BofA Securities, Inc.*

Q

Okay. That's helpful, George. And just a follow-up on your last comment about the NAND market. Every few years, you see the significant dislocation in pricing and this one is quite severe. You guys noted the benefit that you will recognize in gross margin terms. But can you just remind us on how you're thinking about the impact to revenues based on the NAND price decline? Are you expecting a deceleration in AFA revenues? Or are you expecting elasticity of demand to offset that? Thank you.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Customers' budget in dollars, the current macro environment has been spending less dollars, but they'll probably shift the mix to AFAs, if there's more value in the offering, right? So we see them budget in dollars, Wamsi.

**Wamsi Mohan**

*Analyst, BofA Securities, Inc.*

Q

Okay. But in aggregate terms, would you say that the customer budgets would be up or down like in full in aggregate, whether it's cloud on-prem, all put together?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

I think overall, year-on-year, I think 2023, we expect to be moderated and down relative to 2022, certainly at the start of the year. 2022 had a good start to the year. And so our start of the new calendar year, which is baked into our outlook for the second half of fiscal year, we think people are going to be more cautious overall, Wamsi.

**Wamsi Mohan**

*Analyst, BofA Securities, Inc.*

Q

Okay. Thank you so much, George.

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Yeah, thank you.

**Operator:** Our next question will come from Shannon Cross with Credit Suisse. Please go ahead.

**Shannon Cross**

*Analyst, Credit Suisse Securities Research*

Q

Thank you very much for taking my question. I was just wondering what you're hearing from customers on your Keystone offering. I think, as a service offerings, they are becoming a bit more attractive in an economic downturn. So I'm wondering what kind of traction you're seeing there?

**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

It's early, but good traction. We are focused with a few channel partners who are enabled on selling Keystone. We've had good customer wins, good momentum in terms of our offerings. We brought new innovation to market in the last quarter, both a unified control plane so that you can use either a Keystone-based consumption offering in your environment or our Public Cloud offerings and you can move workloads and licenses across those. So a good amount of innovation. And you're correct, we'll continue to see opportunities to help customers around whatever their kind of buying model is in this environment.

**Shannon Cross**

*Analyst, Credit Suisse Securities Research*

Q

Great and thanks. And Mike I look forward to seeing you on Thursday at our conference.

**Michael J. Berry**

*Chief Financial Officer & Executive Vice President, NetApp, Inc.*

A

I as well. Look forward to seeing on Thursday.

**Operator:** Our final question will come from Kyle McNealy with Jefferies. Please go ahead.

**Kyle McNealy**

*Analyst, Jefferies LLC*

Q

Hey, good afternoon. Thanks very much for the question. You touched on this a bit earlier, but not directly. But does the budget scrutiny that you're seeing right now from some subset of customers' impact their decisions for



provisioning the mix that they're provisioning of all-flash versus hybrid arrays at least for new projects. And I know you mentioned that our all-flash portfolio has leading cost efficiency, but do you expect the mindset to change on how much customers are willing to embrace more all-flash? Will the pockets of slowdown that you're seeing potentially pull everything back and the mix stays relatively on the same trajectory? Thanks.

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**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

I think – thank you for the question. We didn't see customers sort of reevaluating technical decisions about what type of infrastructure to buy. I think they allowed the technical team to choose what was the most value, and they make decisions based on the relative cost effectiveness of disk versus flash, right. I think what we saw was an approval level going up for the same deals what would have been approved by a director, now got taken up to VP what was approved by VP, probably goes up to a CTO. That is what elongated deal cycles in the quarter and/or people shrinking how much they wanted to buy at one time and phasing projects into multiple phases.

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**Kyle McNealy**

*Analyst, Jefferies LLC*

Q

Okay. Thanks very much. That's helpful.

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**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

A

Thank you.

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**Kris Newton**

*Vice President-Investor Relations, NetApp, Inc.*

All right. Thank you, Kyle. I'm going to give it back to George for a couple of closing thoughts.

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**George Kurian**

*Chief Executive Officer & Director, NetApp, Inc.*

While there are near-term economic challenges for every company, we know that our opportunity ahead is substantial, durable and growing. The fundamentals of our business are strong and the value we bring customers is undeniable. Our strategic growth opportunities all-flash arrays, cloud storage and cloud infrastructure optimization are tightly aligned to customers top priority and represent the potential for long-term sustained and profitable growth. We will continue to be disciplined stewards of the business, focusing on our strategic growth opportunities while continually optimizing our operating costs to drive shareholder value. Thank you.

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**Operator:** The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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